PRESENT LAW AND PROPOSALS

RELATING TO EMPLOYER-PROVIDED

RETIREE HEALTH INSURANCE

Scheduled for a Joint Hearing

before the

SUBCOMMITTEES ON TAXATION AND DEBT MANAGEMENT
AND
PRIVATE RETIREMENT PLANS AND OVERSIGHT
OF THE INTERNAL REVENUE SERVICE

of the

SENATE COMMITTEE ON FINANCE

ON JULY 19, 1989

Prepared by the Staff

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INTRODUCTION

The Subcommittees on Taxation and Debt Management and Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance have scheduled a joint hearing on July 19, 1989, on employer-provided retiree health insurance issues.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules and proposals, relating to employer-provided retiree health insurance. The first part describes present-law tax rules; the second part is an analysis of tax incentives for prefunding retiree health liabilities; and the third part is a description of certain proposals currently under consideration by Congress, including S. 812 (introduced by Senator Pryor) and proposals before the House Committee on Ways and Means.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Proposals Relating to Employer-Provided Retiree Health Insurance (JCX-35-89), July 19, 1989. See also Joint Committee pamphlet, Present Law and Issues Relating to Employer-Provided Retiree Health Insurance (JCS-15-89), June 12, 1989.

I. PRESENT LAW

A. In General

Under present law, employer-provided post-retirement medical benefits are generally excludable from the gross income of a plan participant or beneficiary. Present law provides two tax-favored funding arrangements to accumulate assets to provide post-retirement medical benefits separately from other retirement benefits. First, separate accounts in certain qualified retirement plans may be used to provide post-retirement medical benefits (sec. 401(h)).

Although assets allocated to a post-retirement medical benefit account are accorded tax treatment similar to that provided for other assets held by a qualified retirement plan, the benefits provided under post-retirement medical accounts are required to be incidental to the retirement benefits provided by the plan. The incidental benefit requirement may preclude funding the entire post-retirement medical benefit through a separate account in a qualified plan.

The second funding medium that can be used to prefund post-retirement medical benefits is a welfare benefit fund (secs. 419 and 419A). Welfare benefit funds generally are not subject to the contribution limits applicable to the separate accounts under a qualified plan, but are subject to separate limits on the deductibility of employee contributions. In addition, medical benefits provided through a welfare benefit fund are excluded from the employee's gross income unless the benefits are provided on a discriminatory basis. However, income set aside in a welfare benefit fund to provide post-retirement medical benefits generally is subject to income tax.

Although advance funding of post-retirement medical benefits is not accorded tax treatment comparable to that provided for retirement benefits under qualified retirement plans, they also are not subject to the same minimum standards applicable to retirement plans.

In addition to the two methods described above for funding post-retirement medical benefits, plan participants may, of course, use distributions from qualified plans to purchase post-retirement medical benefits. The use of such retirement plan distributions to purchase post-retirement medical benefits is equivalent to the purchase of such benefits on an after-tax basis from other income.

Many proposals in this area involve the funding of defined benefit pension plans and the use of the assets of such plans that are in excess of those necessary to satisfy

all plan liabilities ("excess assets"). Subject to certain limitations, an employer may under present law make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets.

Under present law, excess assets may be returned to the employer at the time the plan terminates (sec. 401(a)(2)). The employer who receives a reversion of such assets must include the amount in its gross income. The amount is also subject to a 15-percent excise tax (sec. 4980).

Under present law, excess assets in a defined benefit pension plan may not be used on a tax-favored basis to fund a section 401(h) account or a VEBA.

B. Employee Tax Treatment of Post-Retirement Medical Benefits

The value of employer-provided coverage under a health plan that provides post-retirement medical benefits to former employees, their spouses, or dependents is generally excludable from gross income (sec. 106). The exclusion applies whether the coverage is provided by insurance or otherwise. Thus, for example, the exclusion applies if the employer pays insurance premiums for post-retirement medical coverage, or provides post-retirement medical benefits through a trust.

Gross income generally does not include amounts that are paid directly or indirectly to a former employee to reimburse him or her for expenses incurred for the medical care of the former employee or his or her spouse or dependents. The exclusion applies whether the benefits are paid for by employer contributions (sec. 105) or employee contributions (sec. 104).

The Tax Reform Act of 1986 added specific nondiscrimination rules that apply to the value of the employer-provided coverage under all health plans (sec. 89). If a health plan does not satisfy these nondiscrimination rules, then the highly compensated employees or highly compensated former employees participating in the plan are required to include in gross income the excess benefit received under the plan. The excess benefit is, in general, the excess of the value of the employer-provided benefit over the maximum employer-provided benefit that could be provided if the plan were nondiscriminatory. For this purpose, the employer-provided benefit is the value of the health coverage provided by the employer (not the amount of reimbursements received under the plan).

In addition, gross income includes an employee's or former employee's total employer-provided benefit unless the plan meets certain qualification requirements (sec. 89(k)), for example, a requirement that the plan be in writing, and that the employee's rights under the plan are legally enforceable. For this purpose, the employer-provided benefit is the amount of reimbursements received, rather than the value of the coverage (e.g., the insurance premiums).[2]

C. Employer Tax Treatment of Contributions for Post-Retirement Medical Benefits

Current benefits

Post-retirement medical benefits that are not funded through a qualified retirement plan or a welfare benefit fund are generally treated for employer deduction purposes the same as deferred compensation that is provided under a nonqualified deferred compensation plan (sec. 404). Nonqualified deferred compensation is deductible by the employer for the taxable year in which the compensation is includible in the income of the employee, or would be includible in the gross income of the employee without regard to any exclusion of the benefit from the employee's income. Thus, employer contributions to provide post-retirement medical benefits are deductible when the coverage is provided to the former employee.

The deduction rules for post-retirement medical benefits provided through a qualified plan or a welfare benefit fund are discussed below.

Prefunding of future benefits

In general

Under present law, tax-favored prefunding of post-retirement medical benefits can be accomplished in two basic ways: (1) through a tax-qualified pension plan by establishing a separate account under a pension or annuity plan that satisfies certain requirements (sec. 401(h)), or (2) through a welfare benefit fund (secs. 419 and 419(A)). In addition, distributions from qualified plans may be used by the plan participant to acquire post-retirement medical benefits.

Separate account under qualified pension plans

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[2] There are currently several bills pending before Congress that would delay or repeal section 89, including the qualification requirements of section 89(k).

Under the separate account method of prefunding post-retirement medical benefits, a tax-qualified pension or annuity plan may provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents provided certain additional qualification requirements are met with respect to the post-retirement medical benefits (sec. 401(h)). First, the medical benefits, when added to any life insurance protection provided under the plan, are required to be incidental to the retirement benefits provided by the plan. Under Treasury regulations, the medical benefits are considered incidental or subordinate to the retirement benefits if, at all times, the aggregate of employer contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions made after such date, other than contributions to fund past service credits. Additional medical benefits and life insurance protection may be provided with employee contributions.

The second requirement is that a separate account is to be maintained with respect to contributions to fund such medical benefits. This separate accounting generally is determined on an aggregate, rather than a per-participant basis, and is solely for recordkeeping purposes.

The rationale for requiring that the post-retirement medical benefits funded in this manner be subordinate and be provided under a separate account is that such benefits generally are not subject to the minimum standards, such as vesting, funding, and accrual rules, generally applicable to qualified retirement plans. In addition, such benefits are not subject to any Federal guaranty, such as the guaranty provided by the Pension Benefit Guaranty Corporation with respect to pension benefits. Thus, Congress considered it important not only to limit the tax-favored treatment of such benefits but also to ensure that these relatively unrestricted benefits did not reduce the funds contributed to provide nonmedical retirement benefits pursuant to the minimum standards.

The third requirement is that the employer's contributions to a separate account are to be reasonable and ascertainable. Fourth, the plan is required to preclude the use of amounts in the separate account for any other purpose at any time prior to the satisfaction of all liabilities with respect to the post-retirement medical benefits. Fifth, upon the satisfaction of all plan liabilities to provide post-retirement medical benefits, the remaining assets in the separate account are to revert to the employer and cannot be distributed to the retired employees. Similarly, if an individual's right to medical benefits is forfeited, the forfeiture is to be applied to reduce the employer's future

contributions for post-retirement medical benefits.

The final requirement is that, in the case of an employee who is a "key employee" (as defined in sec. 416), a separate account is to be established and maintained on a per-participant basis, and benefits provided to such employee (and his or her spouse and dependents) are to be payable only from the separate account. This requirement applies only to benefits attributable to plan years beginning after March 31, 1984, for which the employee is a key employee. Also, contributions to the separate account are considered annual additions to a defined contribution plan for purposes of the limits on contributions and benefits applicable to retirement plans (sec. 415), except that the 25 percent of compensation limit (sec. 415(c)(1)(B)) does not apply.

If the requirements with respect to post-retirement medical benefits are met, the income earned in the separate account is not taxable. Also, employer contributions to fund these benefits are deductible under the general rules relating to the timing of deductions for contributions to qualified retirement plans. The deduction for such contributions is not taken into account in determining the amount deductible with respect to contributions for retirement benefits. The amount deductible may not exceed the total cost of providing the medical benefits, determined in accordance with any generally accepted actuarial method that is reasonable in view of the provisions and coverage of the plan and any other relevant considerations. In addition, the amount deductible for any taxable year may not exceed the greater of (1) an amount determined by allocating the remaining unfunded costs as a level amount or a level percentage of compensation over the remaining future service of each employee, or (2) 10 percent of the cost that would be required to fund or purchase such medical benefits completely. Certain contributions in excess of the deductible limit may be carried over and deducted in succeeding taxable years.

Welfare benefit funds

An employer may establish a welfare benefit fund to provide for post-retirement medical benefits. A welfare benefit fund is, in general, any fund which is part of a plan of an employer, and through which the employer provides welfare benefits to employees or their beneficiaries.

If a welfare benefit fund satisfies certain requirements, the fund generally will be exempt from income tax. In general, to be tax-exempt, the fund is required to be a voluntary employees' beneficiary association (VEBA) (sec. 501(c)(9)) providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, and no part of the

net earnings of such association may inure (other than through such payments) to the benefit of any private shareholder or individual. In addition, the VEBA generally is required to satisfy certain rules prohibiting the provision of benefits on a basis that favors the employer's highly compensated employees.

Although a VEBA generally is exempt from tax, it is taxable on its unrelated business taxable income (UBTI). Income set aside to provide for post-retirement medical benefits is considered UBTI, although this rule does not apply to a VEBA if substantially all of the contributions to it were made by employers who are exempt from income tax throughout the 5-taxable-year period ending with the taxable year in which the contributions were made.

Certain special rules apply to the deductibility of employer contributions to a welfare benefit fund without regard to whether the fund is a VEBA. Under these rules, contributions by an employer to such a fund are not deductible under the usual income tax rules (sec. 162), but if they otherwise would be deductible under the usual rules, the contributions will be deductible within limits for the taxable year in which such contributions are made to the fund.

The amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year may not exceed the qualified cost of the fund for the year. The qualified cost of a welfare benefit fund for a year is the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to the qualified asset account under the fund for the year, reduced by (3) the after-tax income of the fund.

In general, the qualified direct cost of a fund is the aggregate amount expended (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided, assuming the benefits were provided directly by the employer and the employer was using the cash receipts and disbursements method of accounting. In other words, the qualified direct cost generally represents the amounts expended during the year for current benefits.

A qualified asset account under a welfare benefit fund is an account consisting of assets set aside to provide for the payment of disability payments, medical benefits, supplemental unemployment compensation benefits or severance pay benefits, or life insurance benefits. Under present law, an account limit is provided for the amount in a qualified asset account for any year.

The account limit with respect to medical benefits for

any taxable year may include a reserve to provide certain post-retirement medical benefits. This limit allows amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that funding of post-retirement medical benefits with respect to employees can be completed upon the employees' retirement. These amounts may be accumulated no more rapidly than on a level basis over the working lives of employees with the employer. Funding is considered level if it is determined under an acceptable funding method so that future post-retirement medical benefits and administrative costs will be allocated ratably to future preretirement years.

Each year's computation of contributions with respect to post-retirement medical benefits is to be made under the assumption that the medical benefits provided to future retirees will have the same cost as medical benefits currently provided to retirees. Because the reserve is computed on the basis of the current year's medical costs, neither future inflation nor future changes in the level of utilization may be taken into account until they occur.

The Deficit Reduction Act of 1984 (DEFRA), which added the deduction limitations for contributions to welfare benefit funds, directed the Secretary of the Treasury to study the possible means of providing minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees. The study is to include a review of whether the funding of welfare benefits is adequate, inadequate, or excessive. The Secretary was directed to report to the Congress with respect to the study by February 1, 1985, with suggestions for minimum standards where appropriate. The Tax Reform Act extended the due date for the study to October 22, 1987. This study has not yet been completed.

Qualified plan distributions

An individual may use some or all of a distribution from a qualified plan to acquire post-retirement medical benefits. Such amounts are taxable to the individual under the rules applicable to distributions from qualified plans. Qualified plans thus provide an additional, indirect means of funding post-retirement medical benefits, although the tax treatment is less favorable than if retiree health benefits are provided directly by the employer.

D. Minimum Standards

Under present law, minimum standards of the type applicable to tax-qualified pension plans generally do not apply to post-retirement medical benefit plans. Under both the Code and the Employee Retirement Income Security Act of 1974 (ERISA), qualified retirement plans are required to meet

minimum standards relating to participation requirements (the maximum age and service requirements that may be imposed as a condition of participation in the plan), vesting (the time at which an employee's benefit becomes nonforfeitable), and benefit accrual (the rate at which an employee earns a benefit).

Also, minimum funding standards apply to the rate at which employer contributions are required to be made to ensure the solvency of pension plans. In general, the benefits provided by defined benefit pension plans are guaranteed by the Pension Benefit Guaranty Corporation (PBGC) in order to prevent loss of benefits in the event an employer terminates a plan while it is in financial distress and has not adequately funded pension benefits.

Except for certain nondiscrimination and basic qualification rules, such minimum standards and requirements do not apply to post-retirement medical benefit plans.

Because post-retirement medical benefits are not subject to the same minimum standards applicable to qualified retirement plans, employees' rights to such benefits depend on the particular contractual arrangement between the employees and their employer. The binding nature of such arrangements, as they relate to post-retirement medical benefits, has been the subject of recent litigation. Case law has focused on the right of the employer to terminate post-retirement medical benefits with respect to current retirees. In general, the courts have affirmed an employer's right to terminate a retiree health plan if such right has been unambiguously reserved and clearly communicated to employees. However, the courts have been strict in applying these standards, looking not just at plan documents but also to oral representations. In cases, for example, in which representatives of the employer have told retirees that their benefits would continue for the remainder of their lives, courts have held that the employer could not terminate the retiree health benefits after the employee had retired.

E. Fiduciary Rules

ERISA contains rules governing the conduct of fiduciaries of employee benefit plans. These rules generally apply to all employee benefit plans subject to ERISA, including both employee benefit pension plans and welfare benefit plans. Thus, these rules apply to post-retirement medical benefit plans. ERISA has general rules relating to the standard of conduct of plan fiduciaries, and also specific rules prohibiting certain transactions between a plan and parties in interest with respect to a plan, such as a plan fiduciary.

The general fiduciary standard under ERISA requires that

a plan fiduciary discharge his or her duties with respect to a plan (1) solely in the interest of the plan participants and beneficiaries, (2) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable administrative expenses of the plan, (3) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, and (4) in accordance with the documents and instruments governing the plan to the extent such documents and instruments are consistent with ERISA.

F. Reporting and Disclosure

ERISA contains reporting and disclosure rules that apply to all employee benefit plans, including post-retirement medical benefit plans. These rules generally require that a plan be in writing, and that certain information with respect to a plan be provided to plan participants and to the Department of Labor. Annual reports on welfare benefit plans are also required to be filed with the Internal Revenue Service.

II. ANALYSIS OF TAX INCENTIVES FOR PREFUNDING RETIREE HEALTH LIABILITIES

There have been numerous proposals made in the retiree health area that would allow more extensive tax-favored prefunding by employers of post-retirement medical benefits than is allowed under present law. These proposals generally fall into one of five broad categories that are discussed in more detail below: (1) the VEBA/sec. 401(h) model; (2) the defined health benefit plan; (3) the defined dollar benefit plan; (4) the defined contribution plan; and (5) the qualified retirement plan surplus approach. A key issue in funding post-retirement medical benefits is defining the benefit. Each of the first four categories of proposals defines the benefit in different ways. The fifth funding approach could be used to fund any type of benefit.

The proposals embody several different specific approaches to prefunding of post-retirement health benefits. More generally, there are several approaches which could be taken to address the issue: maintain the present-law tax incentives for prefunding retiree health benefits; create new tax incentives specifically designed to encourage employers to prefund their liabilities; create new specific tax incentives that mandate that employers prefund their liabilities; or mandate the advance funding of liabilities with no change in tax treatment.

A. Present Law Rules

Recently, there has been increasing focus on the value of post-retirement medical benefits that employers have promised their employees, and the issue of funding those benefits. The concern of employers is, in part, a reaction to the issuance of an exposure draft by the Financial Accounting Standards Board ("FASB") of a proposed Statement of Financial Accounting Standards titled "Employer's Accounting for Postretirement Benefits Other Than Pensions." The exposure draft would require employers subject to the FASB rules to disclose the value of unfunded retiree health liabilities on annual financial statements.

The FASB proposal, when effective, may induce the private market to prefund retiree health liabilities to avoid any adverse effect on an employer's balance sheet. Some believe that the new liability which FASB will require companies to disclose will have negative effects on the solvency or perceived solvency of the employers with significant unfunded liabilities. Corporate financing may be harder to obtain for employers reporting large unfunded liabilities for retiree health benefits and, thus, the accounting change may provide an incentive to reduce these liabilities by prefunding.

Absent changes in the tax law or ERISA, employers would retain flexibility in determining how to best provide funds for the employer's retiree health liability.

Market-induced prefunding, while solving financial statement problems, may not improve the security of benefits for employees or retirees because employers may not set aside assets solely for the benefit of employees. For example, amounts set aside for retiree health benefits may not be protected from an employer's creditors in the event of bankruptcy.

If the capital markets do not react negatively to employers with large unfunded liabilities, in lieu of prefunding its liabilities, an employer may attempt to limit or terminate existing plans. To the extent that this reduction or termination is prohibited by the courts, employers might limit promises of benefits to new employees. Such a result could undermine a goal of improving retiree access to health care.

Some argue that the FASB accounting change alone will not alter the economic circumstances of the employer, so that the accounting change will have little economic impact on the employer beyond providing more accurate information to shareholders. These people believe that investors already consider potential liabilities of the employer to pay retiree health benefits, and that any decision to fund, expand, or curtail retiree health benefits will be made irrespective of a change in accounting rules.

Health benefits for retirees could also be provided through an expansion of an employer's pension plans. With the increased benefits, the retiree could choose to allocate his or her retirement funds between health care and other expenses as he or she deems best. From the employer's perspective, this option is generally equivalent to all proposals which seek to create a specific tax preference for retiree health benefits, except that the monies promised are not dedicated to health care and the amounts that the employer can prefund are determined by reference to the funding and deduction rules for pension plans, rather than by reference to projected or accrued retiree health liability. This approach could be utilized under present law only by those companies which do not make the maximum permissible pension contributions. Some would argue that full use of the present-law pension funding limits indicates that sufficient tax expenditures have been made to induce employers to assist employees in planning for their retirement income and health care needs.

This approach allows the retiree complete flexibility in providing for his or her needs. Being solely responsible for health care needs gives the retiree an incentive to economize

on health care costs. This could reduce some of the pressure on health care costs.

On the other hand, some might argue that retirees may not allocate sufficient amounts of retirement income to health care and that the Federal government should mandate or encourage benefit programs that insure at least some minimum level of health care. In addition, as with any plan which only provides dollars and not services, the risk of increases in health care costs is borne solely by the retiree.

B. Tax Preferences For Prefunding

Accelerating the deductibility of employer contributions for retiree health benefits accelerates the revenue loss to the Federal government. Permitting earnings on the funds to accumulate tax free increases the revenue loss to the government. In addition, while pension payments to retirees constitute taxable income, an employer's purchase of health insurance for employees or retirees generally does not, further increasing the revenue loss to the government.

Such tax preferences create subsidies for employees of the limited number of employers who offer post-retirement benefits. This may induce more employers to establish such plans. The earlier funding of such benefits could increase national saving. Nevertheless, as long as the plans are not uniform, the tax subsidy would be distributed unequally across all employers and employees.

Some argue that it is not necessary to create additional tax advantages for funding retiree health benefits, particularly given the fact that very few employers have yet taken advantage of the existing tax-favored means of prefunding (such as the separate account (sec. 401(h)) under a qualified pension plan). The DEFRA limitations on deductions for contributions to welfare benefit funds (discussed above) were enacted as a result of Congressional concern that the prior-law rules, which permitted employers greater flexibility in prefunding, allowed excessive tax-free accumulation of funds. Many of the current proposals for expanding the tax benefits of funding retiree health benefits would reinstate in some form the pre-DEFRA rules.

Congressional concern about the pre-DEFRA rules was caused by discussions among tax practitioners as to the tax-shelter potential of welfare benefit plans, such as retiree health plans. Commentators had pointed out that the combination of advance deductions for contributions and the availability of tax-exemption for certain employee benefit organizations (such as VEBAs) provided tax treatment very similar to that provided to qualified retirement plans, but with far fewer restrictions. This discussion became considerably more active after Congress, concerned that

qualified retirement plans were being used to provide excessive amounts of tax benefits to relatively high income individuals, lowered the limits on annual contributions that could be made to qualified retirement plans and the benefits that could be paid out of such plans. Some articles recommended the use of VEBAs to recoup deductions lost in qualified pension plans after the lowering of the contribution and benefit limitations. Congress was concerned that substantial advance funding of welfare benefits could ultimately have led to an unacceptable tax burden for many taxpayers who do not participate in these programs.

Accordingly, Congress provided that, as a general matter, employers should not be permitted a current deduction for welfare benefits that may be provided in the future (i.e., for liabilities that are not accrued). This treatment is consistent with income tax rules in other areas, which generally match the time a payor deducts a payment and the time the payee includes the payment in income.

Congress also found that it was appropriate to permit a reasonable level of reserves for the funding of post-retirement medical benefits, and permitted employers to make deductible contributions to fund for such benefits over the active life of the employee. Some argue that any expansion of the tax benefits for funding retiree health benefits would simply recreate the tax shelter possibilities that existed before the DEFRA limitations.

Some who favor increased incentives to fund retiree health benefits are concerned that smaller employers in particular tend not to offer post-retirement medical benefit plans. The most immediate beneficiaries of tax preferences for prefunding retiree health care would be large employers and their employees. Some assert that the administrative costs per employee of employee benefit programs are lower for large employers than small employers. A tax preference for post-retirement health benefits could offset some of the higher per-employee administrative cost and lead to increased coverage among all employers. However, because large employers already offer such benefits, they would tend to gain the most from any tax preference that is equally available to all employers.

C. Mandatory vs. Optional Prefunding

Tax-favored prefunding of post-retirement medical benefits could be mandatory or permissive. That is, an employer that has a post-retirement medical benefit plan could be required to prefund the benefits in accordance with specific statutory rules or could be permitted, but not required, to prefund such benefits.

Optional funding has the advantage that it provides an

employer with flexibility in meeting its benefit obligations. However, optional funding may result in inadequate funding of retiree health benefits if other incentives to prefund are insufficient. Because very few employers have taken advantage of existing tax benefits for retiree health benefits, employers may not be willing to fund these benefits without mandatory funding rules. On the other hand, some argue that the present-law tax incentives for prefunding retiree health liabilities generally are inadequate to induce employers to prefund such liabilities.

Because the present-law rules for funding post-retirement health benefits are optional, some argue that retiree health benefits are now similar to pension benefits prior to ERISA when employers generally were not required to set aside sufficient funds to pay promised benefits.

Mandating the funding of retiree medical benefits ensures that sufficient funds will be available to provide the promised benefit. On the other hand, some employers may not be willing to accept a new funding obligation. Mandatory funding could discourage employers from establishing retiree health benefit plans in the future or, if the employer already has such a plan, cause the employer to reduce benefits or terminate the plan. (Such effects could also occur if the reaction of financial markets causes employers to fund retiree health benefits.) Mandated pre-funding could also increase the short-term labor costs for some employers, placing them at a competitive disadvantage to both domestic and foreign rivals that do not have such obligations.

D. VEBA/Sec. 401(h) Model

As is the case with the following three categories of proposals, the VEBA/sec. 401(h) model would allow more extensive tax-favored prefunding of retiree health benefits by increasing the amount that an employer may contribute to a trust on a deductible basis and/or by increasing the extent to which the income of the trust is exempt from tax. The distinctive element of the VEBA/sec. 401(h) model is that no individual employee would, under the proposals, acquire any right to benefits from the trust. This model does include an incentive for employers to use the trust assets to provide retiree health benefits. Generally, such incentive takes the form of an excise tax applicable to assets diverted to other purposes. However, the additional tax-favored prefunding would be permitted even if an employer retained the right to eliminate all benefits with respect to any individual employee.

The advantage of the VEBA/sec. 401(h) model is the flexibility it provides to employers who can retain the right to change the plan in any way they see fit. One disadvantage of the VEBA/sec. 401(h) model is that it allows the employer

to confer tax-favored retiree health benefits on a narrow, select group (i.e., those who qualify for benefits under the plan). Another disadvantage of this model is that it does not provide any benefit security to any employee, thus interfering with an employee's ability to plan efficiently for his or her retirement. This disadvantage could be addressed through the adoption of certain minimum standards.

As discussed below, H.R. 1213, introduced by Mr. Schulze, is an example of the VEBA model. S. 812, introduced by Mr. Pryor, and H.R. 1865 and H.R. 1866, introduced by Mr. Chandler and others, are examples of expanding the use of section 401(h) accounts.

Other proposals use a variation of the VEBA/sec. 401(h) model under which the use of corporate-owned life insurance (COLI) to fund retiree health benefits is facilitated. The key difference between the COLI variation and the basic VEBA/sec. 401(h) model is that the COLI variation generally does not include a trust. Thus, the employer enjoys current access to the assets, which provides further flexibility for the employer with a concomitant reduction in employees' benefit security.

Although it has not been proposed, there is no theoretical reason preventing the use of COLI in connection with the next three prefunding models; the COLI concept is simply a means of obtaining tax benefits.

E. Defined Health Benefit Plan

Like the VEBA/sec. 401(h) model, the defined health benefit plan allows more extensive tax-favored prefunding of retiree health benefits. However, unlike the VEBA/sec. 401(h) model, one condition of this more extensive tax-favored prefunding is that individual employees earn rights to benefits under the trust that the employer may not eliminate or modify.

In general, the defined health benefit plan establishes a particular health plan that is the plan benefit. Such a health plan could be described by reference to the plan that is (or was) provided to active employees. An individual employee's right to coverage under this plan during his or her retirement is earned by virtue of the employee satisfying certain service requirements. The statute could limit the length of service an employer could require for coverage under the plan to, for example, 10 years.

The advantages of the defined health benefit plan are the benefit security it provides to the employees and, depending on the length of the service requirement, the breadth of the class of employees benefiting under the plan. Vesting requirements for post-retirement health benefits with

a service vesting requirement could induce employees to remain with one employer longer than they otherwise would. This could benefit the employer by making it easier to retain trained employees. On the other hand, labor market mobility could be reduced, making workers slower to respond to new employment opportunities.

There are several disadvantages with this type of approach. First, it is difficult to determine what an appropriate level of funding is, because it is difficult to determine what the benefit will be. Increases in the cost of health care are not easily predictable, thus making it difficult to estimate what the benefit will be worth by the time the employee retires. In addition, changes in health care technology and provider methods may occur, thus altering the benefit promise, and making predictions about the appropriate funding levels inaccurate.

Further, there are underfunding and overfunding problems. With respect to the former, the Federal government would be required to address the problem that a plan have insufficient assets to pay the promised benefits. Some commentators have raised the possibility of creating a Federal guarantor for this purpose, similar to the Pension Benefit Guaranty Corporation (PBGC), which ensures retirement benefits under defined benefit pension plans. Proponents of a Federal guarantor argue that a guaranty is necessary to ensure that individuals actually receive their benefits. However, the PBGC is currently operating with a deficit, and recent legislation (the Pension Protection Act of 1987) was necessary to address the financial problems of the PBGC. Such financial difficulties could also arise with respect to a Federal guarantor of post-retirement medical benefits. Indeed, such a guarantor could be required to pay benefits in more situations than the PBGC because of the difficulty of estimating future health care costs.

With respect to overfunding, the problems that have arisen with respect to qualified retirement plans would be present. Appropriate limitations would be necessary so that employers may not use the post-retirement medical plan as a tax-favored bank account. Thus, limitations on the amounts that are deductible would be necessary. In addition, the problem of what to do with any excess assets, (e.g., do they belong to the employer, or does some or all of any excess belong to the employees) which is currently an issue in the pension area, would need to be addressed.

If an individual employee's benefit is expressed in terms of a health plan, rather than a dollar amount, certain administrative problems arise. For example, it is difficult to have employees earn rights in a health plan gradually over time. Some sort of cliff vesting and accrual of employee's rights thus may be necessary. Also, this type of arrangement

makes it difficult for employees to accumulate benefits earned from different employers without inefficient duplication of benefits.

An additional actuarial difficulty exists in determining the extent of the future liability incurred by such a plan. It is a more difficult task to account for price changes in a specific sector than for overall costs. For example, a pension fund can invest in assets such as corporate securities or real estate which typically appreciate as the overall cost of living increases, and thereby insure their promise to provide a prespecified, inflation-adjusted income level. Such a strategy would not be as effective for provision of health services, the price of which has been rising and may continue to rise substantially faster than the overall price level.

As with pension plans, employers typically impose a service requirement before the retiree health benefit is vested in the employee. Because retiree health plans generally specify health coverage levels rather than dollar levels, problems can arise with vesting policies. While complete vesting for pension benefits typically means different retirees receive different retirement incomes based upon their years of service and income, complete vesting for retiree health benefits usually implies full coverage in a group health insurance plan. Unlike pension plans, many retiree health plans require the employee to have been employed immediately before his or her retirement in order to be vested. Consequently, portability of retiree health benefits is more limited than portability of pension benefits. Estimating the funds required for prefunding, therefore, depends upon estimates of the number of employees who will remain with the firm until retirement.

Altering vesting requirements to more closely parallel those for pension plans creates other potential problems. If, for example, 10 years of service were required for complete vesting in any employer's plan, it would easily be possible for one retiree to be completely vested in two or more different health insurance plans. This could create problems of coordination of multiple health insurance policies held by the retiree, and further complicate the calculation of the employer's future liability. Similarly, the concept of partial vesting is difficult to implement when the benefit is measured in units of service rather than measured in dollars.

A substantial advantage to the retiree of a defined health benefit plan is that the risk of cost increases for health care is substantially borne by the employer. As health care costs rise, subject to the employer's co-insurance rate, the increases in cost are borne by the employer because of the promise to provide a specified level of medical coverage.

F. Defined Dollar Benefit Plan

The defined dollar benefit plan is similar to the defined health benefit plan except that the benefit is expressed not in terms of a specific health plan, but in terms of an annual dollar benefit. This dollar benefit would be available to provide health benefits to employees in their retirement. The amount could be paid directly to an insurance company for coverage of employees, could be used by the employer to fund its own self-insured plan, or could be paid to the employee to reimburse him or her for the cost of purchasing health insurance or medical expenses.

The advantages of this type of plan are based on the fact that it is expressed in terms of a dollar amount, rather than a particular health plan. This makes the employer's costs more predictable and controllable. Moreover, the administrative problems described above with respect to the defined health benefit plan do not exist.

One disadvantage of the defined dollar benefit plan is that it shifts to the employees the risk of health care inflation, making it more difficult for employees to plan with certainty for their retirement. As in the case of the defined health benefit plan, a second disadvantage involves the risk of underfunding and the controversy surrounding overfunding. A third disadvantage is that because the benefit is expressed in terms of dollars, there will be constant pressure to allow the money to be diverted to purposes other than retiree health benefits. This would be similar to the pressure to allow use of qualified retirement plan assets for nonretirement purposes.

An employer could accomplish a similar result to this method (and the method described in G. below) under present law through the use of a qualified plan. The employer could provide increased qualified retirement plan benefits, and then the retiree could use the benefits to purchase health insurance. Of course, under this method, the tax consequences to the employee would be different because distributions from qualified plans are includible in income.

G. Defined Contribution Plan

The defined contribution plan is similar to the defined dollar benefit plan except that each employee has an account under the plan to which a portion of every employer contribution is allocated, rather than earning the right to an annual dollar benefit. That account grows like a tax-deferred bank account, earning income that is retained in the account. Upon an employee's retirement, the assets in the account are available to provide health benefits in the same way as the annual dollar benefit under the defined dollar benefit plan.

The advantage of the defined contribution plan approach is its relative simplicity. The underfunding and overfunding problems do not exist, nor do the administrative problems associated with the defined health benefit plan. Moreover, the employer's obligation is even more limited than under the defined dollar benefit plan. Because the employer is not promising a specific dollar benefit, it bears no risk of poor investment return. In addition, accumulated benefits in a defined contribution plan may not be forfeited if the employee changes jobs, thereby making the retiree health benefits more portable.

The disadvantages of the defined contribution plan generally fall into two categories. First, the employees not only bear the risk of health care inflation, as in the case of the defined dollar benefit plan, but also bear the risk of poor investment return. (This can be mitigated to some extent by the use of a type of defined contribution plan, a "target benefit plan," that adjusts for poor investment return.) This makes it even more difficult for employees to plan efficiently for their retirement. Second, the pressure to allow use of the trust assets for purposes other than retiree health benefits will be even more acute than with respect to the defined dollar benefit plan. The use of individual accounts makes the plan seem more like a bank account available for any purpose. This issue is similar to that in the qualified retirement plan area in which the pressure for nonretirement use of assets is much more acute in the case of defined contribution plans and individual retirement arrangements (IRA's).

H. Qualified Retirement Plan Surplus Approach

Under the qualified retirement plan surplus approach, excess assets in defined benefit retirement plans are used to fund retiree health benefits. This is achieved by transferring the excess assets to a separate retiree health benefit trust or to a separate account within the retirement plan trust (i.e., a sec. 401(h) account), or by permitting the excess assets to be used to pay for current retiree benefits. Under the qualified retirement plan surplus approach, this transfer may not be subject to income tax or to the excise tax on reversions (sec. 4980) from retirement plans.

The qualified retirement plan surplus approach may be combined with one of the four models described above by the use of one of such models in the trust or account to which the excess assets are transferred.

The advantage of the qualified retirement plan surplus approach is that it provides employers with the opportunity to satisfy at least some portion of their retiree health obligations without the use of assets that are easily

available for other purposes. Viewed another way, this approach enables employers access to retirement plan surplus without any adverse tax consequences.

One disadvantage of this approach lies in its similarity to the VEBA/sec. 401(h) model. An employer is able to create deliberately a retirement plan surplus. Thus, this approach enables an employer to build a tax-favored fund to use for future retiree health benefits without at the same time providing employees with vested rights to such benefits.

This approach could also undermine the full funding limitation, which caps the amount of deductible contributions that may be made to qualified plans. If assets are transferred from a fully funded plan out of the qualified plan, leaving the plan below the full funding limitation, the employer is entitled to deduct additional contributions that otherwise would not be deductible.

Another disadvantage to this approach is that it may jeopardize the benefit security of the participants in the retirement plan. It is necessary to determine what level of assets should be left in the retirement plan to assure benefit security.

This approach also raises issues as to who the surplus assets belong to, the employer or the employees. For example, should the participants in the post-retirement medical benefit plan be the same as the participants in the retirement plan, or can the excess assets be used for the benefit of a completely different group of employees?

Permitting employers to use excess retirement plan assets for this purpose may also create pressure to permit employers to withdraw pension plan assets for other purposes.

Some have argued that the use of excess pension assets to fund retiree health benefits is, at best, a partial solution to the problem of funding such benefits, since it can only be used by a limited number of employers. Thus, it is argued that a more comprehensive funding method would be more appropriate.

It has also been suggested that in the future there are likely to be fewer overfunded pension plans because the full funding limit was redefined in the Revenue Act of 1987. Thus, it has been suggested that this approach is only temporary, and might best be viewed as a stop-gap approach until more comprehensive rules can be enacted.

III. DESCRIPTION OF PROPOSALS

A. S. 812[3]--Senator Pryor

The bill would expand the present-law rules relating to the use and funding of section 401(h) accounts. These accounts would be permitted to provide for long-term health care benefits, as well as post-retirement health care.

The bill would revise the funding limits applicable to section 401(h) accounts. Under the bill, benefits under a section 401(h) account would be deemed to be subordinate to the pension benefits under the plan if the annual contributions to such account with regard to a participant do not exceed certain amounts. For a defined benefit plan, an employer could contribute the amount actuarially determined to be necessary to fund an annual benefit commencing at retirement of $2,500 for medical benefits and $2,500 for long-term care benefits. For a defined contribution plan (i.e., a money purchase pension plan), the employer could contribute annually to a section 401(h) account an amount not in excess of $825 for medical benefits and $825 for long-term care benefits. These funding limitations would be indexed.

The bill would permit an employee to enter into a salary reduction arrangement (meeting the requirements of section 401(k)) by which the employee could contribute to a section 401(h) account.

Under the bill, an employer would be permitted to withdraw certain excess assets from an on-going defined benefit plan and transfer such amounts to a section 401(h) account. Assets remaining in the plan after such transfer could not be less than the amount of assets necessary to satisfy 125 percent of the plan's current liability. The amount of assets that could subsequently be withdrawn would be reduced if the employer withdraws assets within 5 years of the last such withdrawal. The amount withdrawn would not be subject to income tax or the 15-percent excise tax on reversions from qualified plans.

In order to withdraw assets from a defined benefit plan, an employer would be required to notify its employees and the Secretary of the Treasury. No withdrawal would be permitted until 60 days after such notice. Conforming amendments would

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[3] The "Retiree Health Benefits Preservation Act of 1989" was introduced by Mr. Pryor on April 17, 1989. H.R. 1865, introduced by Mr. Chandler and others on April 13, 1989, contains the same provisions as S. 812.

be made to Title I of ERISA that would permit withdrawals from on-going plans.

Effective date.--The bill would be effective upon enactment.

B. House Committee on Ways and Means Proposal on the Use of Excess Pension Plan Assets to Pay Current Retiree Health Benefits[4]

Under the proposal, a one-time transfer of certain assets would be permitted from a defined benefit pension plan to the section 401(h) account that is a part of such plan.

The assets transferred would not be included in the gross income of the employer nor subject to the 15-percent excise tax on reversions. The transfer would not disqualify the defined benefit pension plan, nor violate the present-law requirement that medical benefits under a section 401(h) account be subordinate to the retirement benefits under the plan. The employer would not be entitled to a deduction when such amounts are transferred into the account or when they are used to pay retiree health benefits.

In order to qualify for the tax treatment described above, the transfer of assets to a section 401(h) account would be required on or before December 31, 1991. In addition, the benefits of plan participants would be subject to the same rules that would apply if the plan had been terminated. Thus, each participant's benefits must be fully vested and an annuity must be purchased to fund such benefits.

The amount of excess assets that could be transferred and used for retiree health benefits would be limited to the lesser of (1) the assets in excess of the full funding limitation (using 140 percent of current liability instead of 150 percent); and (2) the assets needed to satisfy current retiree health liabilities.

Current retiree health liabilities would be defined as the amount of retiree health benefits estimated to be paid or incurred by the employer during the employer's 1990 and 1991 tax year for employees who have retired as of the date of the transfer.

The amounts transferred to the section 401(h) account would be required to be used to pay current retiree health

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4 The Committee on Ways and Means adopted this proposal on July 12, 1989, as set forth in the Joint Committee staff document, "Description of Revenue Reconciliation Proposal by Chairman Rostenkowski" (JCX-28-89), July 11, 1989.

benefits. In addition, no deduction would be allowed for 1990 and 1991 for the payment of retiree health expenses except to the extent such payments exceed the amount transferred to the section 401(h) account (including any income thereon). Similarly, no contribution may be made by the employer to a section 401(h) account or a VEBA for expenses relating to retiree health benefits for the 1990 or 1991 plan years that may be funded by the excess assets transferred to the section 401(h) account. Any transferred amounts that are not expended for such liabilities are included in gross income, and are subject to the excise tax.

If an employer transfers assets under this proposal, the employer would be subject to a modified definition of full funding. For the plan year in which the transfer occurs, and for the immediately succeeding 4 plan years, the full funding limit with respect to the plan from which the assets were transferred is modified to use 140 percent (instead of 150 percent) of the plan's current liability.

Under the proposal, regardless of whether the employer transfers excess assets, no contribution would be permitted to a section 401(h) account if the employer is precluded from contributing to the pension plan containing such account because the plan has assets in excess of the full funding limitation. This rule would not apply to a transfer of assets made pursuant to the proposal.

Effective date.--The provision generally would apply to plan years beginning after December 31, 1989. With respect to the rule prohibiting contributions to section 401(h) accounts contained in fully funded plans, the proposal is effective for plan years beginning after December 31, 1989.

C. Industry Group Proposal on Use of Excess Pension Plan Assets[5]

Under the proposal, excess pension plan assets would be available for voluntary transfer to a retiree medical trust ("RMT") to pay health benefits for retirees. The amount eligible to be transferred, the recoverable pension surplus, would be the difference between the lesser of market or actuarial value of assets in the pension plan and the lesser of (1) 100 percent of "actuarial accrued liability" plus normal cost as of the latest valuation (including the effects

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[5] This proposal has been developed by an industry group known as the Coalition for Retirement Income Security ("CRIS"). The description of the proposal reflects the written testimony of John E. Stair, Jr. before the Oversight Subcommittee of the House Ways and Means Committee on June 14, 1989.

of future pay increases) or, (2) 125 percent of current liability.

Amounts transferred would not be subject to income and excise tax and no vesting or annuitization of pension liabilities for active or retired employees would be required.

Assets available for transfer would be limited to the amount of eligible retiree health liability (including a provision for medical cost trend and medical inflation) for current retirees at the date of transfer. The eligible group includes all retirees who have health care coverage at company expense.

The initial transfer would be permitted at any time at the employer's discretion as long as the conditions for transfer are met on that date. A maximum of three transfers would be permitted in a ten year period.

Assets that were transferred would not be used to provide retiree health benefits for retirees other than those who were participants in the transferor plan except as provided below.

Transfers would be reflected as plan amendments for the purposes of minimum and maximum pension funding rules. In the event of a certified actuarial surplus, the eligible group could be enlarged to include new current retirees. After satisfaction of all liabilities under the plan(s), excess assets in the RMT shall revert back to the pension plan from which the funds were drawn.

Income earned on assets transferred to the RMT would remain free of income tax or unrelated business income tax. No minimum standards (e.g., coverage, nondiscrimination, vesting or minimum funding requirements) would apply to the RMT. The RMT would be permitted to provide different levels of retiree health benefits according to the provisions of the health care plan(s).

D. H.R. 1213[6]--Mr. Schulze

Under the bill, a reversion from an overfunded pension plan would not be included in the gross income of the employer and would not be subject to the 15-percent excise tax on reversions if the employer transfers more than 50 percent of such reversion to a qualified retiree health trust.

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[6] The "Worker Health Benefits Protection Act of 1989" was introduced by Mr. Schulze on March 1, 1989.

The bill also would allow an employer to withdraw certain excess assets from a defined benefit plan (other than a multiemployer plan) without terminating such plan. This withdrawal would not be treated as a reversion subject to the income and excise tax on reversions. The assets remaining after the withdrawal could not be less than those assets necessary to satisfy 115 percent of the accrued benefits under the plan. Further, in no event could the assets remaining after the withdrawal be less than the assets which would be necessary to satisfy all termination liabilities. The amount of assets that could subsequently be withdrawn is reduced if the employer withdraws assets within 5 years of the last such withdrawal.

In order to withdraw assets from a defined benefit plan, the bill would require the employer to notify its employees and the Secretary of the Treasury of the planned withdrawal. No withdrawal is permitted until 60 days after such notice. Conforming amendments would be made to Title I of ERISA to permit withdrawals from ongoing plans.

Under the bill, amounts withdrawn from an ongoing plan or transferred upon the termination of a plan would be contributed to a qualified retiree health trust. This trust would be tax-exempt and would be required to be maintained for the exclusive benefit of the employees. Contributions and benefits under the trust could not discriminate in favor of highly compensated employees.

The bill would also allow the Secretary of the Treasury to guarantee certain loans the proceeds of which are to be transferred to a qualified retiree health trust. Certain employers with operating losses or loss carryforwards would be eligible for these loans.

The bill would increase the full funding limit from 150 percent to 200 percent of current liability. Under the bill, the excise tax on reversions from qualified plans would be increased from 15 to 20 percent of the amount of the reversion.

Effective date.--The bill would be effective on the date of enactment.

E. H.R. 1866[7]--Mr. Chandler and Others

The bill contains all the provisions of S. 812 as well as other provisions.

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[7] The "Retiree Health Benefits and Pension Preservation Act of 1989" was introduced on April 13, 1989, by Mr. Chandler and others.

Under the bill, the excise tax on reversions (sec. 4980) would be increased from 15 percent to 100 percent. The amount of the reversion would no longer be subject to income tax. If the employer withdraws and transfers such excess assets to a section 401(h) account, those amounts would not be subject to income or excise tax.

The bill would repeal that portion of the full funding limit that prohibits an employer from contributing to a defined benefit plan if the plan has assets equal to or greater than 150 percent of its current liabilities.

Under the bill, a plan would not be a qualified plan if it permitted a distribution prior to the participant attaining age 59-1/2 and if the distributions are more rapid than the rate of distributions under an annuity for the life of the participant. Exceptions to this requirement would include: (1) distribution to a beneficiary upon the death of the participant; (2) distributions on account of the participant being disabled; (3) distributions on account of hardship; (4) distributions after the participant separates from service and has attained the age of 55 (as long as the otherwise applicable rate of distribution requirements are met); (5) transfers to other retirement programs; (6) distributions pursuant to qualified domestic relations orders; and (7) distributions for medical expenses that are described in section 213. The bill would clarify that the last category of distributions would include distributions for expenses related to nursing home care or for long-term care (including premiums for insurance).

Under the bill, the additional income tax imposed on early distributions (sec. 72(t)) would be increased from 10 to 20 percent.

Finally, the bill would require certain employers to provide their employees with the opportunity to create a simplified employee pension account.

Effective date.--The bill would be effective upon enactment.